Top Down Analysis [*]

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Top Down Analysis: a method used by professional traders to analyze the financial markets from the long term, down to the short term perspective.

- In stock trading, a trader begins with the major market averages like the Dow Industrials, S&P 500, and the NASDAQ Composite, to determine the general market direction.
- Once this is established, the industry groups are referenced for leaders and laggards.
- Futures traders use the US Dollar Index as a way to either get long or short the dollar.
- If the US Dollar Index is poised to move higher, this would indicate a lack of risk tolerance and what I refer to as a "risk off" environment.
- Foreign currencies will see selling pressure as the US Dollar moves higher.
- If the US Dollar Index is poised to move lower, this would indicate a return to risk tolerance and what I refer to as a "risk on" environment.
- Foreign currencies will see buying pressure as the US Dollar Index moves lower.
- The Commitment of Traders (COT) report is released weekly.. every Friday afternoon. It usually contains data from the previous Tuesday.
- The COT reports provide a breakdown of each Tuesday's open interest for markets in which 20 or more traders or hedgers hold positions equal to, or above, reporting levels established by the CFTC.
- The COT report breaks down open interest of large trader positions into "Commercial" and "Non-Commercial" categories.
- Commercial traders are required to register with the CFTC by showing a related cash business for which futures are used as a hedge.
- The Non-Commercial category is comprised of large speculators - namely the commodity funds.
- The balance of open interest is qualified under the "non-reportable" classification that includes both small commercial hedgers and small speculators.
- The most important thing for the individual trader to examine is the net position changes from the prior report.
- Note if the Commercial traders are long or short.. and follow them.
- Current and future interest rate prospects are the most important factors to consider when trying to forecast the long term direction of a currency.
- Currencies are highly sensitive to any economic news that can affect the country's interest rates, an important factor for traders of all time frames to understand.
- When the central bank of a country raises interest rates, this not only affects the short term rate that they target, but the interest rates for all types of debt instruments.
- If the central bank of a country raises interest rates, then debt instruments of all types are going to become more attractive to investors, all else being equal.
- This not only means that foreign investors are more likely to invest in the debt of that country, but also that domestic investors are less likely to look outside the country for higher yield, creating more demand for the debt of that country and driving the value of the currency up, all else being equal.
- When a central bank lowers interest rates, then interest rates on all types of debt instruments for that country are going to be less attractive to investors, all else being equal.
- This not only means that both foreign and domestic investors are less likely to invest in the debt of that country, but that they are also more likely to pull money out to seek higher returns in other countries, creating less demand for, and a greater market supply of that currency, and driving its value down, all else being equal.

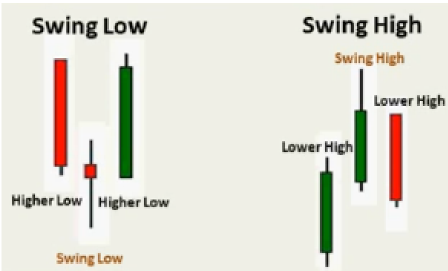
Interest rate hike > lower economic growth > slower inflation
Interest rate cut > higher economic growth > faster inflation

- Foreign investors are not only exposed to the potential profit or loss from interest rate changes on the debt instrument they are investing in, but also to profits and losses which result from fluctuations in the value of that country's currency.
- If you notice a failure swing in the yields on the 2 year note, 5 year note, 10 year note, & 30 year treasury yields, you should anticipate a swing or reversal to come into the bond market.
- The shift or "divergence" of one or more of the yields is easy to spot.
- You only need to see one yield put in a failure swing and it does not matter which one fails to confirm lower lows or higher highs.
- As the yields move higher at some point there will form a failure swing as one yield fails to post higher highs on the line chart.. this is all you need to signal confirmation that the US Dollar is poised to slide lower. [*]
- As the yields move lower at some point there will form a failure swing as one yield fails to post lower lows on the line chart.. This is all you need to signal confirmation the US Dollar is poised to rally higher. [*]

US Yields Increase = Bullish US Dollar

- As a top down analyst, we want to begin our study on the monthly charts and look for key support & resistance levels and try to determine the long term trend or directional bias.

- After consulting the monthly chart, we zoom down to a weekly chart and repeat the process of analyzing the weekly chart as we did on the monthly.
- After we note the essentials from both monthly and weekly time frames, we turn our analysis to the daily chart.. where the process is repeated.
- Once we have our key S/R levels on all the long term perspective charts we can really zoom down to intraday charts for fine tuning entry and exits on trades determined from the higher time frames.
- This in essence is the core of top down analysis in trading.



- It is vital that you learn to spot swing highs and swing lows as they form and can anticipate their formation at or near key support and resistance levels.
- Once you see their formation complete these are referred to as fractal highs and lows.
- We can determine probable trend direction by using these reference points on all time frames.
- The time frames I like to use are the daily, 4 hour, and 60 minute charts.
- Once you find a swing low that formed most recent, this is the "pivot point" that must be breached to the down side before market flow turns down. The swing lows that formed to the left of this swing low are not considered for market flow analysis.
- Once you find a swing high that has formed most recent, this is the "pivot point" that must be breached to the up side before market flow turns up. The swing highs that form to the left of this swing high are not considered for market flow analysis.
- Only the most recent swing high and low are utilized for determining market flow.. and they are dynamic and change as new swings form we disregard the previous ones.
- Using the market flow on the daily, 4 hour, & 1 hour charts can give you the directional bias to trade in with entry points found on a 15 minute chart.
- If all 3 higher time frames agree, this is strong.. but focus on the 4 hour market flow for consistency.

TOP DOWN ANALYSIS

1. Study the US Dollar Index for general market direction.
2. Refer to the COT report and note the Commercial traders net position.
3. Consider commercial traders as the "smart money" and thus try to position like trades.
4. Refer to and monitor daily the 2 year note, 5 year note, and 10 year note on a line chart overlay.
5. On the t-note overlay, we look for failure swings to provide clues to the future direction of the US Dollar.
6. If the yields are dropping and one of the 3 yields fails to make a lower low, we look for the US Dollar to bounce. [*]
7. If the yields are rising and one of the 3 yields fails to make a higher high, we look for the US Dollar to slide lower. [*]
8. A bullish US Dollar translates to lower foreign currencies.
9. A bearish US Dollar translates to higher foreign currencies.
10. We look at the monthly, weekly, & daily charts of the currency pairs we trade, noting key S/R levels.
11. We determine market flow on the daily, 4 hour, and 60 minute charts via swing highs and lows.
12. We try to trade in sync with the long term (top down) directional bias and when the 4 hour market flow is in sync with it. This will filter many false signals and assist us in high probability trade setups.
13. When there is no clear definable direction, we remain flat and sidelined until there is a clear bias.